No. 86-490

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

ILLINOIS CEREAL MILLS, INC.,
Respondent.

ILLINOIS CEREAL MILLS BRIEF IN OPPOSITION TO THE PETITION OF THE UNITED STATES FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Dated: October 31, 1986

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QUESTIONS PRESENTED

The single question presented in the Petition merges at least three separate issues which arise under the now-repealed investment tax credit (Section 38 of the Internal Revenue Code of 1954). These issues are:

1. Whether the Seventh Circuit correctly rejected Petitioner's contention that the hypothetical adaptability of equipment used to carry electricity to operate machinery in a factory prevents such property from qualifying for the now-repealed investment tax credit.

2. Whether the Seventh Circuit correctly concluded that the basis of an asset, in this case a primary electrical system, can be allocated, based on the use of the asset, between basis qualifying for the now-repealed investment tax credit and basis which does not qualify.

3. Whether the Seventh Circuit correctly concluded that for investment tax credit purposes a trial court may allocate the cost of a large, complex, integrated system such as the primary electrical system of a manufacturing facility on the basis of the overall use of the system, or whether the trial court must, as a matter of law, inquire into the specific circumstances surrounding each individual asset which is a part of the integrated system.

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STATUTES AND REGULATIONS INVOLVED

In addition to the materials set out by Petitioner in the Appendix to its Petition, Section 1.48-1(b)(2) of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) is relevant. This portion of the Regulations is set out in Appendix A, *infra.*

STATEMENT OF THE CASE

Respondent submits the following as an addition to the statement of the case found in the Petition for Writ of Certiorari in this case.

This case was tried in the United States Tax Court prior to the decision of the United States Court of Appeals for the

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[1] Illinois Cereal Mills, Inc. is not affiliated with any other corporate entities other than its wholly-owned subsidiaries.

Fourth Circuit in *A.C. Monk & Co. v. United States*, 686 F.2d 1058 (4th Cir. 1982). Petitioner, however, did not argue in the Tax Court that adaptability was a factor to be used in determining whether property, which would otherwise qualify for the investment tax credit, was disqualified as a structural component under Treas. Reg. § 1.48-1(e)(2). Consequently, no record was made of the extent to which the primary electrical system involved in this case, or specific portions thereof, might be adaptable to other uses. If the Court agrees with Petitioner and concludes that adaptability is controlling, and further determines that a "miscarriage of justice" will result if a remand is not ordered, the case will have to be remanded to the Tax Court for a factual determination on this issue.

In addition, Petitioner characterizes the parts used to make up the primary electrical system as "standard". (Pet. 2; Pet. 10). While the referenced material paraphrases the second page of the Seventh Circuit's opinion (Pet. App. 2a), the word "standard" was not used by the Seventh Circuit. Thus, Petitioner's "standard" characterization is not based on any finding of the Tax Court or the Seventh Circuit.

Petitioner also asserts that, if this case had arisen in the Fourth Circuit, respondent "would have been entitled to a smaller credit as the Commissioner contended in his notice of deficiency." (Pet. 11.) This is sheer speculation by Petitioner. There is nothing in the record of this case which suggests that any of the components of the primary electrical system are adaptable.

The amount of the investment tax credit in dispute in this case is less than $10,000.

Respondent received the Petition for Certiorari on October 1, 1986.

REASONS FOR DENYING THE WRIT

I.

THIS CASE IS NOT AN APPROPRIATE VEHICLE FOR THE COURT'S CONSIDERATION DUE TO THE LATE INTRODUCTION OF CERTAIN ARGUMENTS NOW PURSUED BY PETITIONER

The fundamental question which Petitioner asks this Court to consider is whether the test for determining if an asset constitutes a structural component of a building for purposes of the investment tax credit is its hypothetical adaptability to uses other than its present and intended use. Petitioner's position is that if an asset included in the list of examples of structural components in Treas. Reg. § 1.48-1(e)(2) is hypothetically adaptable, it is a structural component and thus cannot qualify as Section 38 property for purposes of computing the investment tax credit, regardless of its present or intended use. Petitioner further contends that adaptability must be determined on an asset-by-asset basis—considering each circuit breaker, switch, wire, etc. individually rather than considering the integrated primary electrical system as a whole—and that each asset must be found to be either qualified for the investment tax credit in its entirety or not qualified at all.

This adaptability argument was first advanced by Petitioner in this case in its brief to the Seventh Circuit. It was not presented to or examined by the United States Tax Court. Since the Seventh Circuit agreed with the conclusions of the United States Tax Court, it was not necessary for it to determine whether the adaptability issue properly could be raised for the first time on appeal. If this Court were to issue a Writ of Certiorari and conclude that the Seventh Circuit was in error with regard to the adaptability test and its application, the Court would then need to decide whether the adaptability issue had been properly preserved. *Riley Co. v. Commissioner*, 311 U.S. 55 (1940). Under the standard enunciated by this Court, an issue not raised in a lower court

should not be considered by the appellate court unless the failure to do so would result in a "miscarriage of justice". *Hormel v. Helvering*, 312 U.S. 552, 558 (1940). *See Singleton v. Wulff*, 428 U.S. 106, 120–21 (1975); *Helvering v. Salvage*, 297 U.S. 106, 109 (1935). No such injustice is readily apparent in the present case. Consequently, this case should be affirmed even if the Court were to conclude that the Seventh Circuit erred with regard to the substantive issue of adaptability.

Despite the nominal amount of tax involved in this case, Petitioner asks the Court to consider it on account of the overall importance it sees in the issue. However, the asserted importance of this particular case is contradicted by Petitioner's failure to appeal the decision in *Scott Paper Co. v. Comm'r*, 74 T.C. 137 (1980). Contrary to Petitioner's statement (Pet. 5, n. 3), the final decisions in *Scott Paper* were entered on June 26, 1985. (See Appendix B, *infra.*) Petitioner's time to appeal in *Scott Paper* was allowed to expire over one year ago. See I.R.C. § 7483.

In view of Petitioner's failure to appeal in *Scott Paper* as well as its failure to present at trial the issue of the adaptability of the system or specific items thereof, Respondent contends that this case is not an appropriate vehicle for the Court's consideration.

II.

THE ALLOCATION ISSUES WHICH PETITIONER URGES THIS COURT TO CONSIDER ARE NEITHER IMPORTANT ENOUGH FOR THIS COURT'S CONSIDERATION NOR RIPE FOR THIS COURT'S REVIEW

One of the questions which Petitioner asks this Court to consider is whether a percentage of a primary electrical system can qualify for the investment tax credit even though the remaining percentage of the system cannot qualify because it serves building functions and thereby constitutes a structural component of a building.

The Seventh Circuit determined that such a percentage allocation is proper. Pet. App. 19a. The Fourth Circuit in *A.C. Monk & Co. v. United States*, 686 F.2d 1058 (4th Cir. 1982), erroneously stated that there is no authority in the legislative history, the regulations or the case law which would permit a percentage of a primary electrical system to qualify for the investment tax credit while the remaining percentage of the system does not qualify. The Seventh Circuit correctly cited numerous cases which have allowed investment tax credit by percentage allocation based on use. Pet. App. 18a. Additionally, as the Seventh Circuit noted (Pet. App. 18a-19a), the legislative history of the investment tax credit contains an example of a percentage allocation of an asset for purposes of computing investment tax credit on property used for both business and personal uses. S. Rep. No. 1881, 87th Cong., 2nd Sess. 11–12 (1962). This example is repeated in Treas. Reg. § 1.48–1(b)(2):

> If, for the taxable year in which property is placed in service, a deduction for depreciation is allowable to the taxpayer only with respect to a part of such property, then only the proportionate part of the property with respect to which such deduction is allowable qualifies as Section 38 property for the purpose of determining the amount of credit allowable under Section 38. *Thus, for example, if property is used 80 percent of the time in a trade or business and is used 20 percent of the time for personal purposes, only 80 percent of the basis (or cost) of such property qualifies as Section 38 property.* [Emphasis added.]

The Fourth Circuit's position is so patently wrong that there is clearly no "conflict" here requiring resolution by this Court. It is by no means clear that the Fourth Circuit would reaffirm its decision in *Monk* after reviewing the authorities cited by the Seventh Circuit.

Even if the allocation of the basis of an asset is not permissible for investment tax credit purposes, any difference between an allocation which focuses on a system as a whole as the Seventh Circuit and Tax Court allowed and an

allocation focusing on specific assets as urged by Petitioner is more a matter of appearance than reality. The consequence of the Petitioner's position is simply to force taxpayers to present more detail in justifying the investment tax credit claimed.

While a complex asset such as a primary electrical system can properly be viewed as a single asset, it is really composed of many individual components. Under Petitioner's approach, each of these components would have to be viewed separately to establish those components within the primary electrical system which serve machinery and equipment and those other components which provide electricity for lighting and non-process heating and air conditioning. As a result, Petitioner would require taxpayers to present more exhaustive (and exhausting) analyses of their primary electrical system to establish the individual components which serve equipment rather than building functions. After all of the work is done, any difference in ultimate tax liability is likely to be small, attributable only to the disqualification of specific components such as individual circuit breakers, switches, and wires. There would be no difference if, for example, a factory is engineered with separate primary electrical systems for lighting and for machinery and equipment, as may be done so that power can be shifted to lighting in the event of a partial interruption of power in order to avoid plunging the entire factory into darkness. Thus, the net difference between a "system" approach taken by the Seventh Circuit and the Tax Court and an asset-by-asset approach urged by Petitioner is likely to be small.

III.

THERE IS NO DIRECT CONFLICT ON THE ADAPTABILITY ISSUE

Another question suggested by Petitioner is whether the test for determining that an asset is a structural component depends upon its hypothetical adaptability to other uses. While this issue may be more important in terms of tax

revenues, there is no direct conflict on this issue. The Fourth Circuit opinion in *Monk* rejects a "narrow function test" and requires the *consideration* of the adaptability of a system to other functions. 686 F.2d at 1065–66. The Seventh Circuit in this case strove to understand exactly what was meant by the Fourth Circuit in *Monk*. Pet. App. 15a-17a. It noted that while *Monk* clearly stands for the proposition that adaptability is to be considered to some extent in determining whether a primary electrical system is disqualified as a structural component, the Fourth Circuit gives no clear guidance as to how it is to be considered. The Seventh Circuit concluded that the position originally stated in *Scott Paper*, and reaffirmed in this case *is not* fundamentally irreconcilable with *Monk*. Pet. App. 5a.

The Seventh Circuit ultimately held, based upon the record in this case, that it was satisfied that 95% of Respondent's primary electrical system was qualified property. Pet. App. 13a. Petitioner argued that a primary electrical system cannot be qualified property if it can be converted to serve other equipment. Respondent argued that the sole issue is the present or intended use of the system. The Seventh Circuit considered *both* of these arguments and, despite the absence of an adequate record from the trial court, concluded (Pet. App. 13a):

> Viewing ICM's electrical distribution system in light of the regulations, legislative history and case law, we conclude that the 95% of the system powering ICM's manufacturing equipment is accessory to ICM's business and *not so generally adaptable* that it is disqualified from ITC treatment. [Emphasis added.]

Thus, the Seventh Circuit *considered* adaptability in this case, as the Fourth Circuit required in *Monk*. The Seventh Circuit did not reject all consideration of adaptability in determining whether an asset is a structural component. It merely concluded that Respondent's primary electrical system was

not *too* adaptable to qualify for investment tax credit. Consequently, there is no direct conflict between the Seventh and Fourth Circuits on this issue.

The diminished significance given to adaptability by the Seventh Circuit is clearly warranted. The Treasury Regulations dealing with structures and structural components, Treas. Reg. §§ 1.48-1(e)(1) and (2), respectively, were carefully drafted to make adaptability a major test for determining whether property is a "structure" but not for determining whether property is a "structural component". Treas. Reg. § 1.48-1(e)(1) includes the following phrase as part of the test for a structure:

> . . . the fact the structure could not be economically used for other purposes.

There is no similar language in Treas. Reg. § 1.48-1(e)(2), which defines a structural component.

Treas. Reg. § 1.48-1(e)(2) instead speaks of items "relating to the operation or maintenance of a building". It describes circumstances where air conditioning and humidification equipment qualifies for investment tax credit. If adaptability disqualified items from investment tax credit, it would hardly be possible for air conditioning and humidification equipment to qualify under any circumstances. What could conceivably be more adaptable than an overly-sophisticated air conditioning system? One need merely change the thermostat setting to adapt it to any use imposing less stringent requirements. Clearly, the present or intended use of the system is controlling under the Treasury Regulations. This view of the Treasury Regulations is supported by the failure of Petitioner to cite any authority from the time of the original adoption of the investment tax credit in 1962 until the decision of the Fourth Circuit in *Monk* which uses adaptability as a test to determine whether an item is a structural component.

IV.

THIS CASE DEALS WITH A REPEALED PROVISION; i.e., THE INVESTMENT TAX CREDIT

Another factor mitigating against consideration of this case by the Court is the repeal of the investment tax credit by Section 211 of The Tax Reform Act of 1986 (Pub. L. No. 99-514), effective generally for assets placed in service after December 31, 1985. This seriously diminishes the continuing importance of the issues here presented to the Court.

CONCLUSION

The Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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